UniCredit

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Five factors that might push Brent back up to USD 100/bbl

Abstract from Oil Update

UniCredit Research

- Demand concerns due to a weakening global outlook are weighing on oil prices.
- We challenge the prevailing market view by highlighting five supply-side factors that might push Brent higher, back up to USD 100/bbl.
- Despite rising recessionary risks, we expect supply shortages to dominate the market narrative over demand destruction fears in the remainder of the year.

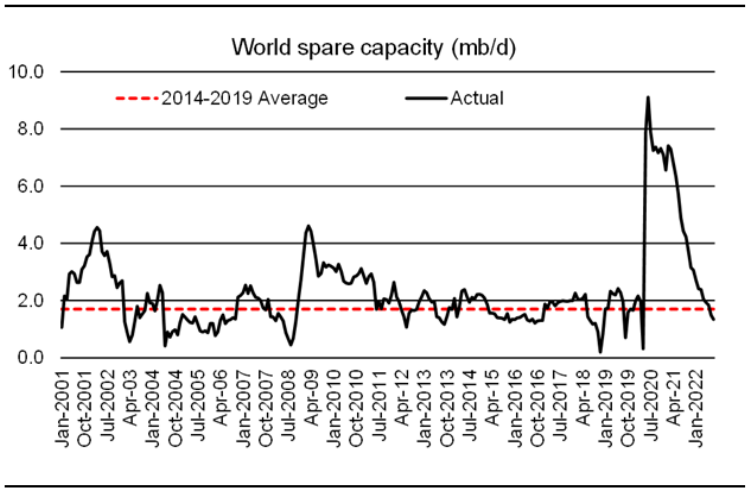
The price of Brent oil is down by about 25% since the peak of last June when a barrel was trading close to USD 125/bbl. Futures contracts for oil delivery in July 2023 change hands at close to USD 80/bbl – almost USD 15/bbl below what the market was pricing in back in June. The balance of risks has clearly changed from fears of undersupply due to opportunistic behavior by OPEC+ to concerns about oversupply due to a weakening global economic outlook. Tighter monetary policies across advanced economies, the energy crisis in Europe, and a weakening real estate sector in China, along with that country's zero-COVID policy, are dragging down world oil demand. If you take out demand increases due to gas-to-oil shifts (more below), the International Energy Agency expects global oil consumption in 4Q22 to be roughly 1% below pre-pandemic levels.

In such a bearish market, where all the attention is on the growing risk of demand destruction, it is easy to overlook supply-side factors that might push oil prices upward in the short term. We identify at least five that could bring Brent prices back towards USD 100/bbl in the next quarter or so. In our view, supply shortages are likely to dominate the market narrative over demand destruction concerns in the remainder of the year.

Factor 1. Spare capacity is increasingly tight

Spare capacity – the volume of production that can be achieved within 30 days and sustained for at least 90 days – is the oil sector's ultimate shock absorber, going up and down depending on demand conditions and production strategies. Around 95% of the world's spare capacity is in the hands of four OPEC+ countries: Saudi Arabia, Russia, the UAE and Kuwait, with Riyadh holding the lion's share (around 30%). As shown in Chart 1, global spare capacity is, at around 1.9mb/d, below its 2014-2019 average. Under normal circumstances, oil prices incorporate a risk premium when spare capacity is too low to allow the market to respond to demand shocks or to potential crises that reduce oil supplies, like a war or a terrorist attack. Therefore, a further decline in global spare capacity – supply is expected to increase by 1mb/d in 4Q22 – is likely to exert upward pressure on prices. The only way for spare capacity to increase in the short term, as the activation of traditional wells might take years and massive investments, is if OPEC+ decided to cut production – something that the market would perceive as bullish for oil prices. And this leads to factor 2.

CHART 1. SHORT OF SPARE CAPACITY



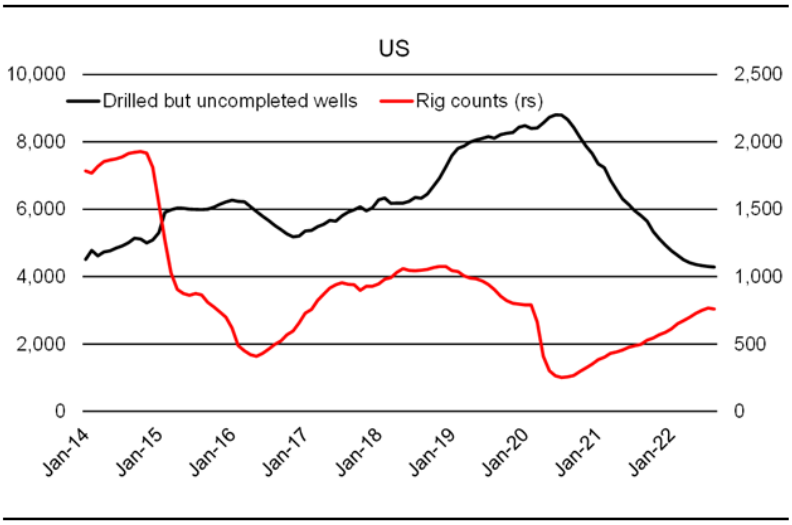
Source: Pira, UniCredit Research

Factor 2. OPEC+ and US producers might undersupply the market

With the notable exception of Saudi Arabia and the UAE, most OPEC+ countries are already operating at full capacity and are struggling to maintain current levels of production after years of underinvestment due to the pandemic and the green transition. But OPEC+ might decide to cut production strategically in order to support prices in the wake of a weakening global outlook. At its September meeting, OPEC+ agreed to a nominal 100 kb/d supply cut for October, ostensibly to signal its willingness to stabilise the market in case of need. Especially those producers that are having more trouble honouring their quotas might insist on the need of a new output agreement. Russia itself might be in favour to boost its oil revenues. Moreover, a nuclear deal with Iran looks now less likely than a couple of months ago – meaning that around 1.5mb/d might no longer hit the market in early 2023 as the market was expecting. Last August, the EU put forward a final text for the agreement, but Teheran coldly received it and ongoing protests in the country following the killing of a young lady risks to destabilize the domestic political situation.

Looking at the other side of the Atlantic, US producers might provide less of a buffer than we expected a few months ago. Although US crude production is now almost back to pre-pandemic levels (around 13mb/d), the boost to output is coming from existing wells and not from new investments despite highly favourable market conditions. Chart 2, which shows rig counts and the number of drilled but uncompleted wells (DUCs), indicates that the recovery in production has been facilitated by existing wells and not by the discovery of new sources. After the huge revenue losses recorded in 2020 as a result of mobility restrictions and the price war between Russia and Saudi Arabia, last year financially weak shale companies took advantage of the price recovery to pay down debt and to return cash to shareholders through increased dividends and share buybacks. They shifted, in other words, to maintenance mode from expansion mode. The consequence of this conservative approach is underinvestment that risks endangering future production and future cash flows as companies rapidly activate DUCs to compensate for the declining productivity of existing wells, whose average life is just 12-18 months – implying that some could get exhausted already in the very short term.

CHART 2. LACK OF INVESTMENT IN THE US



Source: EIA, UniCredit Research

Factor 3. The clock is ticking for Russian oil

So far, Russian oil has proved rather resilient despite the massive deployment of sanctions and self-sanctions. Moscow has diverted part of its production to Asia, away from Europe, and it has adopted different strategies to clandestinely move its oil to Western markets. However, the EU embargo on Russian crude oil and petroleum products imports that comes into effect in December 2022 and February 2023, respectively, is expected to lead to the disappearance of at least 2mb/d of Russian production, down towards 7mb/d. Moreover, the EU ban on maritime services and the G-7 price cap on Russian oil complicate life for Moscow on managing the international flows of its crude. This is something that financial markets should have already priced in, but in the current market bearishness this may have been heavily discounted as the impact on the physical market is not yet visible.

Factor 4. Government petroleum stocks are just a short-term fix

IEA member countries released nearly 180mb of government stocks from March through August (roughly equivalent to 1mb/d), with a further 52mb scheduled for the next two months. So far, the release of strategic reserves has played an important role in providing some price relief. However, it is unclear how much, if any, additional reserves will be released after November. Moreover, reserves are unevenly distributed across the world. The US and China maintain, in almost equal shares, around 70% of global strategic stocks and could accommodate domestic demand for around 30 days. By contrast, Europe, which is the most vulnerable to the Russian shock, has less than 15 days of forward cover. When a certain stockpile depletion threshold is crossed, oil prices might move up again, even if higher demand is being met, because there would then no longer be enough barrels in reserve to address a future emergency – the reason why strategic reserves are created in the first place.

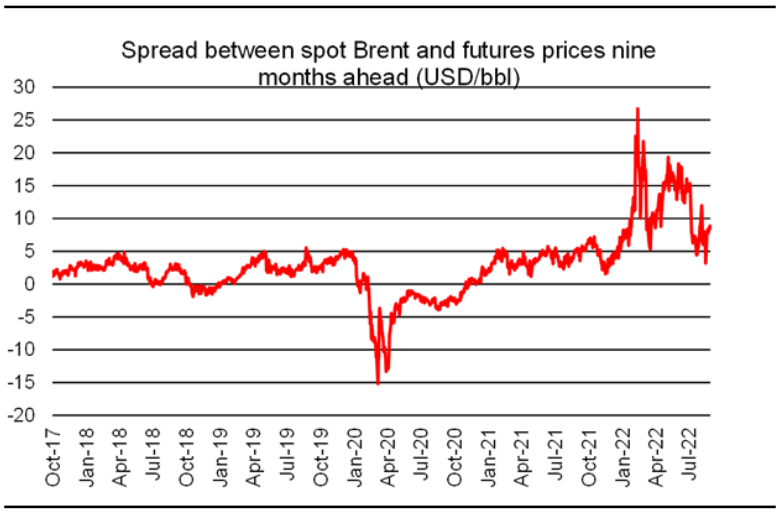
Factor 5. Geopolitical risk is likely to intensify

The war in Ukraine is entering a delicate phase. President Putin has initiated a partial mobilization of Russian reservists and Russian-backed separatists in Ukraine's Luhansk region and in the Donetsk People's Republic are expected to hold a referendum on joining Russia in the next few days. In addition, explicit and public nuclear threats have become part of the rhetoric of Putin's inner circle. Even without getting to such extremes, a further escalation of the conflict would likely put upward pressure on oil prices through the geopolitical risk premium. The spread between the spot Brent price and futures nine months ahead – a proxy of short-term market pessimism – is currently around USD 8/bbl, well below the USD 20/bbl that was reached at the beginning of the war when it hit a historical high (chart 3).

Moreover, the conflict in Ukraine is having a direct impact on the oil market through negative spillover from the natural gas market. EIA expects additional demand of about 700kb/d in 4Q22 and 1Q23 from gas-to-

oil switching as soaring prices for natural gas and LNG push more power producers, refiners, and industrial users to burn fuel oil and other liquid fuels. These estimates are likely to go up in the coming months if Russia decides to further curtail gas supply to Europe.

CHART 3. COMPRESSED GEOPOLITICAL RISK PREMIUM



Source: Bloomberg, UniCredit Research